Tiff Macklem: Floating dollar, anchored inflation - the role of the exchange rate in Canada's monetary policy framework

Remarks by Mr Tiff Macklem, Deputy Governor of the Bank of Canada, to the Lunenburg Board of Trade, Lunenburg, Nova Scotia, 8 June 2006.

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The first thing I'd like to say is . . . Happy Birthday! And many, many more. Two hundred and fifty-three years of hard work and civic pride have made Lunenburg the beautiful and historically rich place it is today. I'm very pleased to be here with you on this occasion.

I'm happy to have been invited by the Board of Trade to speak about the role of the exchange rate in Canada's monetary policy framework. The Canadian dollar is very much in the news these days. And so I want to put exchange rate movements into context, and Nova Scotia is a good place to do that. With a commercial history that goes back centuries, Nova Scotians have a long experience with trade and currencies. From the early 1700s, when they were alleged to possess, and I quote, "a canniness in trade that staggered even the Scotch,"[1] to the energy and agri-food exports of today, Nova Scotians have always been outward-looking, engaged in trade, and thus interested in the value of currencies.

Over the next 20 minutes, I'd like to explain the role of the flexible exchange rate in our economy. I'll start by providing a useful backdrop—the Bank of Canada's monetary policy framework. Next, I'll take a close look at the flexible exchange rate, and discuss how the Bank considers currency movements in its monetary policy decisions. I'll then comment on the recent appreciation of the Canadian dollar, and conclude by discussing the challenges that the rapid appreciation of our currency is posing. At the end of my remarks, there will be time for comments and questions.

The monetary policy framework

The ultimate goal of the Bank of Canada is to promote the economic and financial welfare of Canadians. To achieve this goal, we need a clear, effective policy framework.

The two key components of the Bank's monetary policy framework are an "anchor," the inflation target, and a "float," the flexible exchange rate. Living by the ocean, you know better than I that a good mooring is one that keeps a boat in place, yet allows some give and take for the wind and the tide. And so it is for our framework. We need an inflation target to anchor our policy with a clear objective. We also need the flexible exchange rate to pass on valuable price signals and to absorb some of the ups and downs of the global economy. The two components work hand in hand and reinforce each other to promote the economic well-being of the nation. Let me elaborate first on the "anchor," the inflation target.

Out of the bitter experience of the 1970s and early 1980s, we learned that the best contribution that monetary policy can make to the welfare of Canadians is to keep inflation low and stable. In 1991, the Bank and the Government of Canada formalized this commitment to low inflation by announcing an explicit inflation target. Since 1995, the target has been the 2 per cent midpoint of a 1 to 3 per cent inflation control range. The inflation target has proven to be very effective—indeed, it has been the most successful regime in Canadian monetary policy history. Inflation has been low and stable, and we've experienced solid growth and less volatility in output and employment.

To keep inflation at 2 per cent, the Bank tries to maintain a balance between the overall (or aggregate) demand for, and supply of, goods and services. When aggregate demand and supply are in balance, the economy can operate at its full production capacity, and inflation is stable. To achieve this balance, the Bank raises interest rates when aggregate demand pushes the economy above its sustainable production capacity, causing price pressures to build and inflation to rise above the target. And, in a

[1] John C. Miller, *Origins of the American Revolution* (Stanford University Press 1959, 12)

symmetric fashion, the Bank lowers interest rates when unused capacity puts downward pressure on inflation, pushing it below the target.

Inflation control contributes to better economic performance in several ways, but let me highlight two of them. First, low and stable inflation enables firms and individuals to have confidence in the value of money and to read price signals clearly, helping them to make sound long-term economic decisions. Second, when inflation is contained, and the economy is running close to capacity, we can deal more effectively with economic shocks. Resources can more easily be reallocated from sectors where demand is relatively weak to sectors where demand is relatively strong. This is especially important at times, like now, when there are large movements in relative prices—that is, in the prices of some goods, such as energy products, relative to other prices.

Meeting the inflation target helps to anchor expectations of inflation, and that in itself helps to keep inflation low and the economy relatively stable. Also, and importantly, the explicit goal of the inflation target acts as an anchor in our decision-making process at the Bank of Canada.

Let me now turn to the other key component of Canada's monetary policy framework—the "float"—the flexible exchange rate.

Let's start with a basic question: Why allow the dollar to float? The fundamental reason is that a flexible currency allows us to follow an independent monetary policy, a policy suited to our own economic circumstances. We wouldn't be able to address the particulars of the Canadian economy if we set monetary policy with the goal of maintaining a fixed exchange rate. With just one instrument to carry out monetary policy, we can have only one target—and we target inflation.

But there's another important reason for having a flexible exchange rate. Just as a properly moored ship has some play in the mooring lines to absorb changes in the wind and the tide, the floating dollar helps the economy to absorb shocks—especially external shocks that affect our economy differently than the economies of our major trading partners. That is, it helps us adjust to shifting currents in the global economy. It's useful to think of the exchange rate as a *relative price*, a price that provides a good deal of useful information. Movements in the exchange rate send signals to businesses and consumers, signals that help the economy adjust to changing circumstances.

But just because the Bank of Canada does not have a target for the Canadian dollar does *not* mean that we ignore the exchange rate. Far from it. For any significant currency movement, we try to assess the implications for aggregate demand in Canada, and thus the implications for monetary policy. And, as part of this analysis, we try to determine the factors driving a given movement. Let me expand on this.

Interpreting currency movements

The Canadian dollar can rise or fall for a number of reasons. But, in principle, we can divide exchange rate movements into two categories—Type One and Type Two. Type One exchange rate movements reflect changes in the aggregate demand for Canadian goods and services. Type Two movements reflect other factors. The key point is that these two types of currency movement have different implications for monetary policy. In general, there's less of a need for monetary policy to respond to a Type One movement than to a Type Two movement. But just to make life interesting for central bankers, *both* types of movement may occur at the same time. Interpreting currency movements is not a science; it requires judgment.

In Canada, Type One currency movements often relate to the health of the global economy, which in turn is reflected in the foreign demand for, and world prices of, the commodities we produce in this country. When global demand is strong, and world commodity prices rise, the value of the goods that Canada exports increases, and this tends to cause the Canadian dollar to appreciate. This appreciation provides an offsetting force, dampening foreign and domestic demand for Canadian-produced goods and services. To the extent that this dampening effect offsets the initial direct increase in demand, there's no need for a policy response. Aggregate demand and supply remain in balance, and inflation stays on target.

A Type Two exchange rate movement is one that is *not* triggered by a change in aggregate demand for Canadian goods and services. But, as you might expect, the currency movement *itself* affects the demand for Canadian goods and services, by making them more, or less, competitive relative to goods and services produced elsewhere. Other things being equal, this is a situation to which

monetary policy needs to respond to keep aggregate demand and supply in balance, and inflation on target.

Type Two exchange rate movements are more difficult to describe, both because they are best defined as anything that is not Type One, and because the distinction is not always as clear in practice as it is in theory.

One example of a Type Two exchange rate movement is the "portfolio shock" that can arise when there is a sudden reassessment of risk by global investors, often in response to an economic crisis somewhere in the world. When this happens, there is a so-called "flight to quality." That is, investors move out of assets denominated in riskier currencies—typically those of highly indebted countries—and this can lead to a sharp depreciation of these currencies. To the extent that the depreciation reflects the pure portfolio effect that is due to "financial contagion," and not the result of a fall in demand for the goods and services produced by the country, it is a Type Two depreciation. In the first half of the 1990s, when inflation targeting was still very new in Canada, and our government debt was rising unsustainably, Canada was more susceptible to this kind of exchange rate movement.

Another example of a Type Two force, this time in the opposite direction for the Canadian dollar, is the adjustment of the U.S. dollar against most major currencies, reflecting concerns about the U.S. current account deficit. I'd like to elaborate on this as I discuss the recent appreciation of the Canadian dollar.

The recent appreciation of the Canadian dollar

Since the beginning of 2003, the Canadian dollar has appreciated by about 40 per cent relative to the U.S. dollar, and by a lesser amount against a trade-weighted basket of the currencies of our major trading partners. This sharp appreciation appears to be largely the result of two factors: strong foreign demand for Canadian products, especially commodities, and broad-based weakness in the U.S. dollar. That is to say, both Type One and Type Two forces have been at play.

Global economic growth has been strong over this period. Sustained strength in the U.S. economy, combined with tremendous growth in China and other parts of Asia, has led to a surge in world demand and prices for oil and gas, metals, and other commodities that Canada exports. In many respects, what we have been seeing since 2003 is the reverse of what happened as a result of the fallout of the Asian Crisis in the second half of the 1990s, when world growth weakened, commodity prices plunged, and the Canadian dollar dropped to a low of about 64 cents U.S. Indeed, our own research has long found a relationship, in the same direction, between non-energy commodity prices and the value of the Canadian dollar. And our more recent research suggests that, with the substantial growth in our net trade surplus in energy since the early 1990s, energy prices now appear to have an influence (also in the same direction) on the value of the Canadian dollar. So, with the boom in the prices of energy and non-energy commodities since 2003, we have seen a marked Type One appreciation of our currency.

But this is not the whole story. Another factor driving the Canadian dollar higher since 2003 has been a broad-based weakening of the U.S. dollar. The American dollar has fallen against many currencies as a result of concerns about the large and growing U.S. current account deficit. This situation cannot be sustained indefinitely, and investors appear to believe that a depreciation of the U.S. dollar is needed to help resolve this aspect of the "global imbalances." This multilateral currency realignment also appears to be playing a role in the appreciation of the Canadian dollar.

To the extent that the Type One appreciation is working to offset the underlying positive shock to the Canadian economy, there is less need for monetary policy to respond. But the Type Two appreciation is something that monetary policy would want to respond to in the form of a lower policy interest rate *than would otherwise be the case*. Our assessment is that *most* of the exchange rate appreciation since 2003 reflects strong global demand and higher commodity prices. At the same time, part of the Canadian dollar appreciation has been related to the multilateral depreciation of the U.S. dollar, and we have had to factor this Type Two force into our monetary policy decision making.

Weighing all factors, the Bank of Canada has raised the policy interest rate from 2 1/2 per cent to 4 1/4 per cent, as unused capacity in the Canadian economy has been absorbed by strong foreign and domestic demand for Canadian goods and services. Our objective with these rate moves has been to keep the Canadian economy operating at its potential and inflation close to the 2 per cent target over the medium term. Policy interest rates in the United States, by comparison, have increased from 1 per cent to 5 per cent. As a result, while the Canadian and the U.S. economies both appear to be

operating close to their full production capacity, interest rates in Canada are below those in the United States right across the yield curve. And, at longer maturities, the negative spreads with U.S. rates are historically large.

As I said earlier, interpreting currency movements is difficult and requires judgment. The challenge is even more acute during periods of market volatility, such as we've seen in recent weeks.

The challenges of a rapid currency appreciation

At this point, I'd like to make one thing very clear: for many individuals and firms, adjusting to exchange rate changes can be difficult—particularly when the currency moves as far and as quickly as it has in the past three years. While higher commodity prices benefit some firms, others are facing higher energy and non-energy input costs, and new competition from low-cost producers in China and elsewhere. For these firms, the higher value of the Canadian dollar is an added pressure. Some sectors, particularly manufacturing, tourism, the fishery, and forestry, are facing some very real challenges. And some firms, especially in the manufacturing sector, are struggling, and individuals have lost jobs. We are well aware of this, and recognize the stresses that come with such dislocation.

It's important to point out that there's a good deal of diversity *within* each sector of the economy. Not all commodity producers are benefiting from high commodity prices—firms in the paper products and agriculture sectors face difficulties. And some manufacturers, notably in machinery and equipment, and resource processing, are doing well.

What we have been struck by, both in industry visits and in our analysis of the data, is how actively businesses have been responding to the challenges posed by a rapidly appreciating dollar. The Bank of Canada's most recent survey of Canadian businesses shows that about half of the firms surveyed have been adversely affected by the rising dollar, while about a quarter have been favourably affected. Those adversely affected have responded to the strengthening dollar by outsourcing labour-intensive production, specializing in higher value-added products, developing new products and entering new markets, and by improving productivity.

Firms in Nova Scotia and across Canada are looking for ways to adapt to, and thrive in, these challenging times. The fact that they *are* adjusting attests to the strength and resiliency of Canadian business, and to the skills and resourcefulness of our workers. For its part, the Bank of Canada will continue to support the adjustment process by keeping inflation low and stable and the economy operating close to capacity. This contribution is critical to the adjustment process because it enables sectors that are expanding to more readily absorb resources that are released by sectors under pressure. And our focus on inflation control ensures that Canadians can continue to have confidence in the value of their money.

Conclusion

I'd like to conclude by emphasizing that the flexible exchange rate is an essential part of Canada's monetary policy framework. A floating currency absorbs shocks, passes on price signals, and—against a backdrop of low and stable inflation—facilitates adjustment to economic developments.

This framework, of anchored inflation and a floating exchange rate, helps Canada to weather the sometimes stormy seas of the global economy. Whatever the economic circumstances, the Bank of Canada will continue to do its part by keeping inflation under control and the economy expanding in a sustainable fashion.

For business, a floating currency brings both challenges and opportunities. I'm sure that Nova Scotians will continue to seize the opportunities, and, through investment, innovation, and marketing, rise to the challenges.

I'd now be happy to respond to your comments and questions.